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SUBJECT: 2005 CENTRAL GOVERNMENT BUDGET, PART III:
EPILOGUE

REF: (A) Paris 8860 ; (B) Paris 9110 ; (C) Paris 8612

¶1. SUMMARY. This is the last in a series of cables on the 2005 GOF central government (CG) budget. This cable analyzes the questionable assumptions upon which the budget bill was based, and analyzes the budget as finally passed. Final passage of the 2005 budget law occurred December 30 with publication in the French Official Journal. Despite expressing strong confidence in its scenario, the GOF nonetheless announced in January it would restrain spending. In a marked shift of economic policy, the government has decided to subsidize job creation. END SUMMARY.

Unexpected Spending Related to Oil Prices

¶2. The 2005 French budget was signed into law and published in the French Official Journal on December 30. No significant modifications were added to the bill prior to passage, so details are as described ref B. The budget assumptions, therefore, incorporate the biggest uncertainties arising at the end of the year, namely, the rise in value of the euro and increased oil prices. The budget also assumes significant one-time receipts will be realized after partial privatization in 2005 of publicly held energy companies EDF and GDF. EDF will transfer 7 billion euro to the CG to pay pensions in the future for EDF's employees, who currently have a status similar to civil servants.

¶3. In France, oil prices are exacerbated by a very high domestic tax on petroleum products ("Taxe interieure sur les produits petroliers - TIPP). Former Finance Minister Sarkozy promised to provide 123 million euros support to groups hard-pressed by high oil prices, including farmers, fishermen, and truck drivers. The GOF also planned to use value-added tax (VAT) receipts on oil to reduce the effect of the TIPP due to windfall VAT receipts. After opposition arose from other EU members who argued such plans should be coordinated within the EU to avoid threatening competition, Sarkozy announced the creation of a special commission to examine a decrease in the TIPP. Such a decrease was not examined as persistent oil price increases caused a decrease in gas consumption, reducing expected windfall VAT receipts. Eventually, the GOF decided to pay an extra benefit of 70 euros to retirees receiving minimum old-age allowance ("allocation vieillesse minimum") to help them pay for heating bills. Nevertheless, these new expenditures did not get added to projected 2005 expenditures since the GOF was able to fund them with the windfall VAT receipts.

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Despite High Oil Prices and Euro, GOF Sticks to its
Optimistic 2.5% GDP Growth
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¶4. Increasing oil prices and euro both cast a shadow over the GOF scenario when it introduced the CG budget in September. But the new situation failed to dampen the GOF's 2.5% GDP growth forecast. Since September, Prime Minister Jean-Pierre Raffarin has kept repeating that GDP is growing at a 2.5% annual pace, and he has never altered that prediction despite poor third quarter GDP growth (ref C). He acknowledged that the rise in oil prices was high, but argued that business confidence remains high as well. Recently, new Finance Minister Herve Gaymard opined "we have a forecast of 2.5% growth in 2005 which is realistic." The slide in the dollar "should not continue" and is an issue for U.S. and Asian monetary authorities, as well as European ones. The OECD forecast a recovery in the French economy in 2005, but downgraded its GDP growth forecast for France to 2.1% from 2.6%.

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Left and Part of Center-right Criticize the Budget

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¶5. Communists highlighted "insufficiencies of a budget that is far from addressing emergencies and needs related to rising unemployment and poverty." Former Socialist Finance Minister Dominique Strauss-Kahn described the 2005 CG budget as a budget with no economic strategy, based on an unrealistic 2.5% GDP growth forecast. His guess is that GDP growth will not be higher than 2 percent in 2005 as oil prices will be closer to USD 45 per barrel than USD 36.5, the assumption of the GOF forecast. He also stated that the purchasing power of the French would fall in any case since social taxes will be increased by 6 billion euros (the social security deficit will be reported separately). He also warned against a net decrease in youth job creation, and no social progress since inheritance taxes will benefit less than 20 percent of the population and be costly (600 million euros). Socialists and Communists criticized inheritance taxes and a 50 percent increase in the tax relief for employing domestic help, as gifts to the GOF's electorate. In a letter to Le Monde newspaper, Sarkozy denied that the reform of inheritance taxes would only benefit the rich, arguing that 70 percent of the public approved the change. "The tax cut stems from the need not to penalize initiative, not to discourage individual effort, and it responds to the concern of many people that the fruit of their work should be handed on to their heirs."

¶6. To respond to the criticism from the left, the Conservative majority made its "Social Cohesion" plans a priority, backtracking from its liberal (in the French sense) strategy of no longer subsidizing job creation to fight unemployment.

¶7. The center-right Democratic Union party (UDF) announced it would abstain on the budget if the zero-interest loan scheme to home-buyers ("PTZ") was eliminated, the increase in the tax relief for employing domestic help did not take into account the size of families, and if the GOF maintained its reform of rights to pensions paid to surviving spouses of retirees ("pension de reversion"). This new reform was planned as part of the 2005 social security budget. Eventually, UDF passed the budget as the GOF backtracked on the pension issue, and listened to UDF's concerns about PTZ and the tax relief for employing domestic help.

¶8. Deputies contested several technical provisions, resorting to the Constitutional Council, which can review bills and strike unconstitutional clauses before their passage. The Council suppressed a clause in the budget bill limiting the effect of measures designed to prevent job outsourcing. As a result, all companies (not only companies located in certain zones) can benefit from professional tax deductions if they do not move jobs overseas. The Constitutional Council also removed an article on the role of the Tax Council ("Conseil des Impots"), deeming that it was not a budget issue. The initial idea proposed by former center-right minister Jean Arthuis was to transform the Tax Council into a "Conseil des Prelevements obligatoires" that could examine the spectrum of all taxes including social contributions (44% of GDP), and how taxes at large affect taxpayers. The Tax Council is administratively related to the Cour des Comptes (roughly equivalent to the GAO).

COMMENT

¶9. The main problem with the budget is that the GOF 2005 GDP growth forecast is too optimistic. Even if the French economy grows at 2.5 percent, the resulting higher tax receipts might not be sufficient to reduce the budget deficit if even just a few budget expenditures are undervalued. 2005 CG expenditures amount to 242.7 billion euros, setting the deficit at 45.2 billion euros. The 2005 CG budget deficit could even deteriorate in absolute terms compared to 2004, since the 2004 CG deficit was revised to 49.3 billion euros (ref D), and eventually adjusted to 49.5 billion euros by the Parliament. The GOF announced in January 2005 it is limiting spending by 4 billion euros to ensure stability in expenditure growth.

¶10. Another troubling aspect of the budget bill is the reliance on one-time budget boosts. There is nothing wrong with the one-off payment from EDF and GDF, which is a financial transfer similar to the 1997 transfer from France Telecom, but it cannot be repeated every year, nor resolve the structural budget deficit associated with the sheer size of the GOF.
LEACH